Estate Planning Insights

A Quarterly Publication of

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Vol. 13, No. 2 **April 30, 2016**

Bypass Trust Versus Portability–Part 2

Recap. In our last newsletter, we began discussing the options for married couples who may need more than 1 exemption from the federal estate tax to avoid paying estate taxes. As noted, married couples do not "automatically" get 2 exemptions from the federal estate tax just because a couple consists of 2 people. As noted in our prior newsletter, married couples must DO SOMETHING to get 2 exemptions from the federal estate tax.

The American Taxpayer Relief Act of 2012 (ATRA), passed in January 2013, set the exemption from the federal estate tax at $5 million, indexed for inflation, starting from a base year of 2011. As a result, the estate tax exemption amount for 2016 is $5,450,000. Married couples in a traditional marriage whose combined net worth (valuing all assets at "fair market value" and including the proceeds of life insurance) is *significantly* less than that amount should not have to worry about paying estate taxes on the death of the surviving spouse (unless the surviving spouse receives some sort of "windfall" or the assets dramatically grow in value). Such couples should review their Wills or Revocable Trust Declaration to see if their documents *mandate* the creation of a Bypass Trust on the first spouse's death. Older couples in this situation (whose estate may not be growing) may want to obtain new "simple Wills" that leave everything (outright) to the surviving spouse instead of creating a Bypass Trust.

Couples with a combined net worth greater than $5 million need to consider very carefully what to do because they will most likely need more than 1 exemption from the federal estate tax to avoid paying estate taxes on the death of the surviving spouse. When the second spouse dies, estate taxes will be payable at the rate of 40% on the amount above that spouse's $5 million exemption, indexed for inflation. Thus, 1 exemption may not be enough.

There are 3 typical methods for obtaining 2 exemptions from the federal estate tax: (i) create and fund a "Bypass Trust" (also known as a "Credit-Shelter Trust") on the death of the first spouse (assuming the deceased spouse's Will or Trust creates a Bypass Trust); (ii) file a Form 706 and make the "portability election" on the death of the first spouse; and (iii) have the assets owned by the first spouse to die pass to that spouse's children on his death and not to the surviving spouse. Only the first two (2) of these options are used with any frequency by couples in a traditional marriage. The third option is sometimes used by couples in a second marriage.

Another option for avoiding the payment of estate taxes is to leave most or all of the assets to charity. This method is often used by couples with no children, who typically leave their assets to charity on the death of the surviving spouse. However, anyone can leave some or all of his/her assets to charity at death and avoid estate taxes on those assets.

We are not going to repeat the information that was in our prior newsletter, but please read that newsletter before reading the rest of this newsletter. The bottom line is this: if a married couple desires to shelter from federal estate taxes 2 times the exemption amount, or $10,900,000 under current law, they must do something more than create a "simple" estate plan.

Bypass Trust Approach. In Part 1 of this series, we focused on the Bypass Trust approach. The majority of our married clients with a net worth between $6 and $40 million are still using the Bypass Trust approach. The Bypass Trust approach provides multiple benefits in addition to preventing the *waste* of the estate tax exemption amount of the first spouse to die, such as protecting the assets in the trust from loss due to (i) the surviving spouse's remarriage and (ii) a judgment against the surviving spouse obtained as a result of a lawsuit. In addition, most Bypass Trusts are structured to provide increased income tax options every year. Further, a Bypass Trust also prevents the waste of the GST Exemption of the first spouse to die. Most wealthier clients use GST Exemption planning by creating divorce and creditor-protected trusts for their children (to receive the couple's assets when the second spouse dies), which go on to their grandchildren when their children die. We are not going to repeat all of the benefits of the Bypass Trust in this newsletter because we promised to discuss the other major option–*portability*–this time.

Portability Approach. If all of the assets owned by the first spouse to die pass directly (outright) to the surviving spouse on his death, the first spouse will be "wasting" his exemption from the federal estate tax. That is because, assuming the surviving spouse is a U. S. citizen, a direct transfer from the deceased spouse to the surviving spouse qualifies for the unlimited marital deduction. Because of the unlimited marital deduction, there is no estate tax on that transfer. Thus, no exemption is used. However, as a result of that transfer, the surviving spouse (who is just 1 person) now owns 100% of the assets. If the total value of the surviving spouse's estate exceeds her own $5 million exemption, adjusted for inflation, estate taxes will be due on the excess when she dies.

<u>Example</u>: A couple owns $6.4 million of community property assets. Husband dies and leaves his $3.2 million to wife. Wife now has a $6.4 million estate. Wife's estate will be distributed to the children upon her death. Estate taxes will be payable at 40% on wife's estate minus wife's exemption amount. Ignoring future changes in the value of both the assets and the exemption amount, and rounding the current exemption amount to $5.4 million, estate taxes of $400,000 will be payable on the wife's death ($6.4 million - $5.4 million = $1 million x 40%).

If this couple does not want to use a Bypass Trust to avoid paying estate taxes when the second spouse dies, the *executor* of the first spouse's estate (which is usually the surviving spouse) can file a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return ("Form 706"), and make the election to transport the deceased spouse's unused estate tax exemption amount (called the "DSUE Amount") to the surviving spouse. This is called *making the portability election*. In that way, the surviving spouse will have her own $5 million exemption amount *plus* the DSUE Amount to cover her estate when she dies. This means that she could have $10,900,000 (or more) of exemption.

The *advantages* of the Portability Approach are:

1. The assets owned by the first spouse to die can be left outright and free of trust to the surviving spouse. Thus, there is no trust to set up and fund (simplifying estate administration and distribution) and no trust to administer during the surviving spouse's life.

2. The "capital assets" owned by the surviving spouse when she dies will obtain another adjustment to income tax basis (also referred to as "cost basis") upon her death, equal to their fair market value at that time. Capital assets are "investment-type" assets, such as real property, stocks, bonds and mutual funds. In contrast, there is no second adjustment to income tax basis for the capital assets owned by the first spouse to die that are placed in a Bypass Trust and still held in the trust when the surviving spouse dies. This *adjustment* in income tax basis that occurs when the owner of the assets dies is often referred to as a "step up" in basis. However, it could be a "step down" in basis if a particular asset has depreciated below its original cost by the time of the owner's death.

3. The surviving spouse can leave all of the assets she receives from the deceased spouse to whomever she chooses when she dies. She can also make gifts of all or any part of the assets to whomever she desires while she is living. Thus, there are no "restrictions" on the transfer of the assets that she receives from the deceased spouse.

The *disadvantages* of the Portability Approach are:

1. A Form 706 must be filed on the first spouse's death to make the election (extra work and expense).

2. There is no portability of the first spouse's GST Exemption amount and many couples with larger estates include GST planning (i.e., create lifetime, divorce and creditor-protected trusts for their children that also provide tax benefits) as part of their estate plan.

3. If the surviving spouse remarries and her new spouse predeceases her with less *unused* exemption than her first spouse (which is almost always the case

because couples in a second marriage tend to leave their exemption amount either to their children from their prior marriage or to a Bypass Trust), the DSUE Amount transported to the surviving spouse when the first spouse died is "wiped out" and cannot be used by her estate upon her death. Thus, when a surviving spouse is relying on the portability election and is about to remarry, the surviving spouse may need to make *taxable gifts* to her children, using the DSUE Amount, so that the DSUE Amount won't be "wiped out" if her new spouse dies before she does.

4. There is no "growth factor" for the DSUE Amount—it is frozen as of the first spouse's date of death. Compare that to the fact that all appreciation in the value of the assets held in the Bypass Trust escapes estate taxation on the death of the surviving spouse.

5. There is no creditor protection (i.e., lawsuit protection and divorce protection) for the assets left directly to the surviving spouse as there would be if those assets had instead been placed in a Bypass Trust. There is also no "ultimate control" (*see* next section) for the first spouse's assets when they pass directly to the surviving spouse--they could end up with a new spouse of the surviving spouse.

Second Marriages. In a second marriage situation, there are additional issues to consider besides estate taxes. Frequently, each spouse in a second marriage has a child or children from his/her prior marriage. Thus, there is "tension" between typical planning for estate tax avoidance and "ultimate control." By *ultimate control* we mean that spouses in a second marriage usually want to take care of each other before any significant amounts are distributed to their children from their prior marriages, but each spouse also wants to make sure that, when the surviving spouse dies, his/her part of the assets ends up with his/her own children (and not entirely with the children of the surviving spouse and certainly not with the new spouse of the surviving spouse). *Ultimate control* issues in a second marriage situation almost always mean that some sort of trust will be created for the benefit of the surviving spouse when the first spouse dies.

The trust that is created for the surviving spouse in a second marriage situation could be *either* a Bypass Trust *or* a Marital Trust. A Marital Trust is somewhat simpler to administer than a Bypass Trust because all income earned by the Marital Trust assets each year must be distributed out of the trust to the surviving spouse. For this purpose, income usually means interest, dividends, and other "ordinary" income. In contrast, most Bypass Trusts are drafted to allow the Trustee to retain or accumulate all or any part of the income in the trust each year and to allow the Trustee to distribute the trust income not only to the surviving spouse but also to any one or more of the children and grandchildren of the deceased spouse (and sometimes other persons as well). Also, if the first spouse to die creates a Marital Trust for the surviving spouse and the combined net worth of the couple exceeds $5 million, then it is likely that the portability election will have to be made when the first spouse dies. That is because a standard Marital Trust does not provide the estate tax avoidance benefits that a Bypass Trust provides. So, while the Marital Trust approach has some advantages, it also has the "disadvantage" in certain cases of having to file a Form 706 to make the portability election (in addition to setting up and funding the trust).

As noted earlier, sometimes couples in a second marriage skip the surviving spouse completely, with each spouse leaving his/her respective assets to his/her own children upon his/her death. This can leave the surviving spouse without sufficient assets for his/her support, however. In the case where the first spouse to die (suppose that's the husband) leaves all or any part of his estate to his children from his prior marriage on his death, he will not be "wasting" his estate tax exemption amount. His estate tax exemption amount *will* be applied to the transfer of his assets to his children, to eliminate estate taxes on that transfer. So, this approach does not end up wasting the exemption of the first spouse to die. Again, however, skipping the surviving spouse completely as a beneficiary of the first spouse's assets can leave the surviving spouse without sufficient resources for her support and maintenance. So that is why many couples in a second marriage situation still create a trust for the surviving spouse on the first spouse's death. However, if the surviving spouse is the Trustee of the trust, it can be "difficult" for her to administer it because the deceased spouse's children are the "remainder beneficiaries" of the trust. In that case, a corporate Trustee can be appointed instead. In any case, wording should be included in the trust to try to prevent lawsuits from being filed against the Trustee by the children of the deceased spouse, who may challenge investment and distribution decisions.

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Time For an Estate Planning Check Up? If (i) you are in a traditional marriage, (ii) your Wills were executed prior to January 2013, (iii) your Wills contain a Bypass Trust, and (iv) your combined estate is well below $5 million (and not growing), you should come in for a check up. You may be able to switch to "simple Wills." In addition, regardless of your marital status or net worth, if your estate plan has not been reviewed in over 7 years, it's time for an estate planning check up. Further, married couples with a net worth greater than $11 million and single clients with a net worth greater than $6 million ought to come in to discuss whether it's time to take one of the many "second steps" up the estate planning ladder.

As everyone is aware, we send quarterly newsletters as a courtesy to our clients (and others). We try to be informative and we also try to point out significant changes in the law. However, our newsletters are not intended as a substitute for regular estate planning check ups. As stated in our contracts, once a particular estate planning engagement is finished, we do not have a continuing duty to contact clients to inform them regarding changes in the law and how those changes might affect their estate plan. So, just as in the case with your doctor, you must determine if it is time to schedule a "check up" appointment. When we do meet with clients to review their estate plan, we often find "problems" resulting from clients not following our instructions with respect to the proper titling of accounts and/or the completing of beneficiary designation forms. These items affect your estate plan, too–maybe even more than your estate planning documents. So, if it has been a long time since you have come in to review your estate plan, then you are "over-due" for a check up. We hope to see you soon!

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above, or by email sent to:

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